

**COORDINATED ISSUE
UTILITIES INDUSTRY
CAPITALIZATION OF COSTS - UNCLASSIFIED LABOR COSTS
UIL 263A.03-05**

Issue:

Does section 263A of the Internal Revenue Code require a taxpayer to capitalize costs attributable to the time of an employee normally engaged in production activities when such time is not attributable to any particular production activity (often referred to as "unclassified labor costs" or "unclassified time" by regulatory agencies)?

Facts:

Large regulated utility companies ("taxpayers") own and service extensive networks of cable, wires, poles, switches, circuits, and other related utility property. In general, this property is constructed by employees of the taxpayers' construction departments, and is considered property produced by the taxpayers under section 263A of the Code.

Construction department labor costs include the labor costs for both engineering and plant employees. Engineering employees plan and design construction and maintenance projects. Plant employees perform the specific construction or maintenance projects.

Consistent with the requirements of the relevant regulatory body, construction department employees post their time to one of three categories: classified, unclassified, and fringe benefits. The classified category contains time spent that can be identified with a specific construction (i.e., production) or maintenance project.¹ In contrast, the unclassified category contains time spent that is general in nature and cannot be associated with any particular project (see list below). The fringe benefits category contains paid hours when the employee is away from work and includes vacation pay, holiday pay, and sick pay.²

¹Taxpayers are allowed a current deduction for classified time allocable to a maintenance project.

²Taxpayers are permitted to allocate the costs of fringe benefit time between construction and maintenance projects and to deduct currently the costs allocable to the maintenance projects.

The unclassified category may be broken down by the taxpayer into categories such as:

- Paid union activities during work hours
- Excellence Through Quality/Quality of Work Life Program activities
- Travel time due to a permanent transfer from one location to another when first reporting to a new location
- Assessment Center attendance to analyze promotion potential
- Tests taken in conjunction with job bids
- Company-sponsored open house
- Shareholder interviews during working hours
- Career continuation training
- Classroom time for general training (excluding on-the-job training and job specific classroom training hours which are reported directly to the final code appropriate for the training received)
- School visit program
- Drivers training
- Sales and marketing classes
- Bad weather time
- Report preparation not unique to a given undertaking
- Motor vehicle breakdown time and time waiting for a vehicle to be towed due to mud, snow or sand (excluding incidental hours which are charged to the work using the company motor vehicle)
- Severance pay
- Military pay

Some taxpayers take the position that construction costs attributable to the classified and fringe benefits categories should be capitalized, but they do not capitalize any of the costs in the unclassified category.

Law:

Section 263A of the Code provides uniform rules for capitalization and inclusion in inventory costs of certain expenses. Section 263A(b) provides, in part, that section 263A applies to real or tangible personal property produced by the taxpayer. Section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve.

Where section 263A applies, a taxpayer must include in inventory costs or capitalize the direct costs and the proper share of those indirect costs (including taxes) part or all of which are allocable to such property subject to section 263A.

Section 1.263A-1(e)(3)(i) of the regulations³ provides that a taxpayer must capitalize all indirect costs properly allocable to property produced. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of production activities. Indirect costs may be allocable to both production activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production and other activities.

Section 1.263A-1(e)(3)(ii)(A) of the regulations⁴ provides that among the indirect costs that must be capitalized with respect to production activities are indirect labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i)(B) of that section). The specific elements of indirect labor costs that are subject to capitalization include basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan.

Other types of indirect costs that must be capitalized include pension and related costs (section 1.263A-1(e)(3)(ii)(C)) and employee benefit expenses (section 1.263A-1(e)(ii)(D)).

Section 1.263A-1(e)(3)(iii) provides that certain indirect costs are not required to be capitalized, including, for example, selling and distribution costs (section 1.263A-1(e)(3)(iii)(A)) and strike expenses (section 1.263A-1(e)(3)(iii)(G)).

Analysis:

Taxpayers take the position that the unclassified time of the construction department employees is entirely unrelated to production, and thus the costs are not required to be capitalized under section 263A. However, to the extent that the employees are normally engaged in production activities, these costs are indirect labor costs of a production department and should be capitalized.

Section 263A requires the capitalization of the direct costs and indirect costs that directly benefit or are incurred by reason of the production of property. The "directly

³The final regulations for section 263A were adopted on August 6, 1993 and are effective with respect to costs incurred in taxable years beginning after December 31, 1993. Section 1.263A-1(e)(3)(i) of the final regulations replaced temporary regulation 1.263A-1T(b)(2)(ii), both of which contain essentially the same language.

⁴For costs incurred in taxable years beginning before January 1, 1994, see section 1.263A-1T(b)(2)(iii)(E) of the temporary regulations.

benefit or incurred by reason of" language recognizes that an indirect cost does not need to directly benefit a production activity in order to be capitalizable. An indirect cost is also capitalizable if the cost is incurred by reason of the performance of the production activity.

The following four step process should be considered in determining whether a taxpayer has capitalized the proper amount of costs of a particular department. The first step is to determine whether section 263A applies to any of the department's activities. Section 263A applies to the production of real or tangible personal property. Here, a utility company's construction department produces self-constructed assets. Accordingly, section 263A applies to the construction department.

The second step is to identify which costs are allocable to the department. All costs that are potentially subject to capitalization under section 263A (including service costs allocated from other departments)⁵ must be included in the department's costs. The costs of classified time, unclassified time, and fringe benefits, of full time employees of a department should be included in the costs allocable to that department. In the case of employees that are part-time employees of a department, an allocable share of these costs must be included in the costs allocable to the department.

The third step is to determine which, if any, of the costs that have been allocated to the department are exempt from capitalization under section 263A. See section 1.263A-1(e)(3)(iii). The costs of unclassified time may not be excluded unless a particular cost is excluded from capitalization under the section 263A regulations. See sections 1.263A-1(e)(3)(ii)(A) and 1.263A-1(e)(3)(iii).

The fourth step is to divide the remaining costs between the production and nonproduction activities performed by the department. The costs allocated to the production activities must be capitalized and included in the bases of the self-constructed assets. The costs that are allocable to the nonproduction activities are not required to be capitalized under section 263A.

Thus, under the facts presented in this paper, the costs of classified time, unclassified time, and fringe benefits that are allocated to the production activities of the construction department must be capitalized and included in the bases of the self-constructed assets. The costs of classified time, unclassified time, and fringe benefits allocated to the construction department's nonproduction activities (e.g., repair and maintenance activities) are not required to be capitalized under section 263A.

Taxpayers argue that unclassified time is conceptually similar to temporarily idle equipment and facilities, of which depreciation, amortization, and cost recovery

⁵See § 1.263A-1(e)(4).

allowances are excepted from capitalization by section 1.263A-1(e)(3)(iii)(E) of the regulations.⁶ The temporarily idle exception only applies when equipment and facilities are completely (albeit temporarily) removed from service. It does not apply to regular temporary removals from service, such as "removals" on nonworking days. See section 1.263A-1(e)(3)(iii)(E) of the regulations.⁷ The unclassified time at issue here is not similar to the "temporarily idle" exception because the unclassified time does not relate to periods when the construction department employee is completely "out of service." On the contrary, it is closer to a nonworking day in that the employee is still normally engaged in, albeit temporarily away from, production activities. In this regard, the temporarily idle exception does not support taxpayers' treatment of unclassified time.

Next, taxpayers argue that to the extent unclassified time relates to military leave differential or severance pay, the time is totally unrelated to production because the employee is either on military duty or has left the taxpayer's employment. However, these costs are only incurred because the employee is a construction (production) employee. In this respect, these costs are similar to vacation pay, which even if only incurred while away from work, is required to be capitalized because it is a fundamental component of the employee's compensation. See sections 1.263A-1(e)(3)(ii)(A) and 1.263A-1(e)(2)(i)(B) of the regulations.⁸

Taxpayers also argue that the legislative history to section 263A permits them to deduct the costs of unclassified time. Specifically, taxpayers contend that the legislative history provides that section 263A should be patterned after the section 451 long-term contract regulations and permits "similarly liberal" methods of allocation. The Senate Report states:

The existing long-term contract regulations provide a large measure of flexibility to taxpayers in allocating indirect costs to contracts inasmuch as they permit any reasonable method of allocation authorized by cost accounting principles. The committee expects that the regulations under this provision will adopt a similarly liberal approach and permit allocations of costs among numerous items produced or held for resale by a taxpayer to be made on the basis of burden rates or other appropriate methods similar to those provided under present law.

⁶For costs incurred in taxable years beginning before January 1, 1994, see section 1.263A-1T(b)(2)(v)(F) of the temporary regulations.

⁷*Ibid.*

⁸For costs incurred in taxable years beginning before January 1, 1994, see section 1.263A-1T(b)(2)(iii)(E) of the temporary regulations.

S. Rep. No. 313, 99th Cong., 2d Sess. 142 (1986), 1986-3 (Vol.3) C.B. 142 (emphasis added). The flexibility and liberal treatment to which the legislative history refers is in the methods of allocating costs to property. This flexibility, however, does not apply to identifying the types of costs that are required to be allocated to property subject to section 263A.

Taxpayers argue that these costs cannot be indirect labor costs because the unclassified time is unrelated to the production of network property. Taxpayers argue that the standard should be similar to the extended period long-term contract regulations (on which section 263A was modeled).⁹ In particular, taxpayers cite section 1.451-3(d)(6)(ii)(L) of the regulations, which provides that administrative costs directly attributable to the performance of a particular extended period long-term contract need be allocated to the contract. However, this refers only to a specific example that does not take into account the introductory language to the examples of costs that need to be allocated. The introductory language in section 1.451-3(d)(6)(ii) of the regulations provides that the indirect costs properly allocable to an extended period long-term contract are all costs that directly benefit the performance of extended period long-term contracts, or are incurred by reason of the performance of extended period long-term contracts. The "directly benefit or incurred by reason of" language in section 1.263A-1(e)(3)(i) of the regulations¹⁰ is similar.

Taxpayers may also contend that the regulations of the regulatory body governing their industry require them to expense the costs of unclassified time for financial reporting purposes. However, a review of FCC regulations, coupled with discussions with the FCC, revealed nothing that requires these costs to be expensed by taxpayers under the regulatory supervision of the FCC. A similar review should be made of other applicable regulations.

Further, even if the applicable regulations do mandate the expensing of unclassified labor costs, these regulations are not necessarily determinative for federal income tax purposes. A case by case analysis is required to determine whether the treatment of an item for financial accounting purposes, as mandated by another agency's regulatory scheme, should also be used for federal income tax purposes, under the standard set forth by the Supreme Court in Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), 1974-2 C.B. 85 (where a taxpayer's generally accepted method of accounting is made

⁹The Senate Report associated with the enactment of section 263A provides that: "The uniform capitalization rules will be patterned after the rules applicable to extended period long-term contracts, set forth in the final regulations issued under section 451." S. Rep. No. 313, 99th Cong. 2d Sess. 141 (1986), 1986-3 (Vol. 3) C.B. 141.

¹⁰For costs incurred in taxable years beginning before January 1, 1994, see section 1.263A-1T(b)(2)(ii) of the temporary regulations.

compulsory by a regulatory agency and that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences).

Conclusion:

Under section 263A, a taxpayer is required to capitalize the unclassified labor costs of an employee normally engaged in production activities, that are allocable to production activities, as explained above, unless a particular cost is exempt from capitalization under the section 263A regulations.

Change in Method of Accounting:

A change from deducting the cost of the construction department's unclassified time in the year incurred to capitalizing part or all of the cost of that unclassified time to the cost of self-constructed assets produced by the construction department is a change in method of accounting to which the provisions of sections 446(e) and 481 apply.

When a district director requires such a change in method of accounting as part of an examination of the taxpayer's return(s), the change in method of accounting will ordinarily be made in the earliest taxable year under examination with the entire amount of the positive section 481(a) adjustment included in the District Director's computation of the taxpayer's taxable income for the year the method is changed. See section 2.10 of Rev. Proc. 97-27, 1997-1 C.B. 680.

When a district director requires the taxpayer to change its method of accounting as part of an examination, it is important to provide written notice to the taxpayer stating that the taxpayer's method of accounting for unclassified labor costs properly allocable to production activities is being changed and clearly labeling the section 481(a) adjustment. It is also important that the written notice describe the proper (new) method of accounting. The written notice should ordinarily be provided in the examiner's report or, when used, in a Form 870AD or closing agreement.